



Advocacy: the voice of small business in government

December 23, 2009

The Honorable Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
E-Mail: regs.comments@federalreserve.gov

Re: Regulation Z; Docket R-1366 Truth in Lending Closed End Credit

Dear Secretary Johnson:

The Office of Advocacy of the U.S. Small Business Administration (Advocacy) submits this comment on the Board of Governors of the Federal Reserve System's (hereinafter, "the Board") proposed rulemaking on *Regulation Z; Docket No R-1366 Truth in Lending*. While Advocacy is pleased that the Federal Reserve prepared an initial regulatory flexibility analysis (IRFA), Advocacy is concerned that the Federal Reserve has not analyzed properly the full economic impact of the proposal on small entities as required by the Regulatory Flexibility Act (RFA).¹ Advocacy recommends that the agencies revise the rulemaking to increase transparency and address the issues below.

Advocacy Background

Congress established the Office of Advocacy under Pub. L. 94-305 to represent the views of small business before Federal agencies and Congress. Advocacy is an independent office within the Small Business Administration (SBA), so the views expressed by Advocacy do not necessarily reflect the views of the SBA or of the Administration. Section 612 of the RFA requires Advocacy to monitor agency compliance with the Act, as amended by the Small Business Regulatory Enforcement Fairness Act.²

¹ 5 U.S.C. §§ 601-612.

² Pub. L. No. 96-354, 94 Stat. 1164 (1980) (codified at 5 U.S.C. §§ 601-612) amended by Subtitle II of the Contract with America Advancement Act, Pub. L. No. 104-121, 110 Stat. 857 (1996). 5 U.S.C. § 612(a).

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In addition, Executive Order 13272 enhances Advocacy's RFA mandate by directing Federal agencies to implement policies protecting small entities when writing new rules and regulations. Executive Order 13272 also requires Agencies to give every appropriate consideration to any comments provided by Advocacy. Under the Executive Order, the agency must include, in any explanation or discussion accompanying the final rule's publication in the *Federal Register*, the agency's response to any written comments submitted by Advocacy on the proposed rule, unless the agency certifies that the public interest is not served by doing so.

Requirements of the RFA

The RFA requires agencies to consider the economic impact that a proposed rulemaking will have on small entities. Pursuant to the RFA, the federal agency is required to prepare an initial regulatory flexibility analysis (IRFA) to assess the economic impact of a proposed action on small entities. The IRFA must include: (1) a description of the impact of the proposed rule on small entities; (2) the reasons the action is being considered; (3) a succinct statement of the objectives of, and legal basis for the proposal; (4) the estimated number and types of small entities to which the proposed rule will apply; (5) the projected reporting, recordkeeping, and other compliance requirements, including an estimate of the small entities subject to the requirements and the professional skills necessary to comply; (6) all relevant Federal rules which may duplicate, overlap, or conflict with the proposed rule; and (7) all significant alternatives that accomplish the stated objectives of the applicable statutes and minimize any significant economic impact of the proposed rule on small entities.³ In preparing the IRFA, an agency may provide either a quantifiable or numerical description of the effects of a proposed rule or alternatives to the proposed rule, or more general descriptive statements if quantification is not practicable or reliable.⁴ The RFA requires the agency to publish the IRFA or a summary of the IRFA in the Federal Register at the time of the publication of general notice of proposed rulemaking for the rule.⁵

Pursuant to section 605(b), in lieu of an IRFA, the head of the agency may certify that the proposed rule will not have a significant economic impact on a substantial number of small entities. A certification must be supported by a factual basis.

The Proposed Rule

On August 26, 2009, the Board issued a proposed rule to amend Regulation Z, which implements the Truth in Lending Act (TILA) and staff commentary as part of a comprehensive review of TILA's closed-end credit. This proposal would revise the rules for disclosure of closed-end credit secured by real property or a consumer's dwelling, except for rules regarding rescission and reverse mortgages. The proposal would require transaction-specific disclosures at least three business days before consummation.

³ 5 USC § 603.

⁴ 5 USC § 607.

⁵ 5 USC § 603.

The goal of the proposed amendments is to improve the effectiveness of disclosures that creditors provide to consumers in connection with an application and throughout the life of the mortgage. The proposal would apply to all closed-end credit transactions secured by real property or a dwelling, and would not be limited to credit secured by the consumer's principal dwelling. The proposed rule makes changes to the format, timing, and content of the disclosures for the four main types of closed-end credit information governed by Regulation Z: 1) disclosures at application; 2) disclosures within three days after application; 3) disclosures three days before consummation; and 4) disclosures after consummation. In addition, the Board is proposing additional protections related to limits on loan originator compensation.

Compliance with the RFA

Preliminarily, Advocacy would like to commend the Board for acknowledging that the proposed rule will have a significant economic impact on a substantial number of small entities and preparing an IRFA. However, Advocacy is concerned that the IRFA may not comply with the requirements of the RFA because it lacks adequate information about the economic impact of the proposal and full consideration of less burdensome alternatives.

Economic Impact

Section 603(a) of the RFA requires agencies to consider the impact of the proposed regulatory action on small entities. Although the Board provides information on the number and types of entities that will be impacted, there is no indication of the nature of that impact or what the proposed regulations may cost. It simply states that the costs of the proposed changes are unknown.⁶

Advocacy spoke with members of the mortgage industry about the potential economic impact of this action on small community banks. According to the Independent Community Bankers of America (ICBA), the proposal may require small community banks to dramatically alter their business practices. If it is too costly, it could possibly lead to community banks leaving the market. This would potentially make it more difficult for consumers, including small entities, to obtain a mortgage.

Moreover, according to the American Bankers Association (ABA) it is extremely expensive to completely revamp the computers, forms, and a financial institution's practices and procedures. All the forms will change and banks may need to also change products. These changes would be in addition to the many changes for financial industry over the last year. Because of the complexity, volume and interplay of all the other changes to the rules, it would be extremely risky for a bank to go forward without expert legal counsel. The Board should acknowledge that additional legal costs will be incurred as a result of these changes.

⁶ 74 Fed. Reg. 43320.

In addition, the National Association of Mortgage Brokers (NAMB) asserts that the proposal treats similarly situated competitors differently by regulating the manner of compensation for some but not others. According to NAMB, this will result in a disparate treatment of the entities that are affected by the regulation. Furthermore, NAMB told Advocacy that small businesses offering loan origination services will be negatively and disproportionately impacted by the proposal because the definition of loan originator in the proposal places restrictions on small businesses that are not placed on larger competitors. Moreover, the proposal prohibits the yield spread premium (YSP) or payments to brokers or any other originator based on a mortgage transaction's terms or conditions.

On page 43236 of the *Federal Register* notice, the Board states that it conducted conference calls and met with industry members throughout the review process leading to the proposal. There is no indication in the preamble that the Board made any attempt to ascertain the costs of this proposal during those conference calls and meetings. The Board could have used those opportunities to learn what the industry would have to do to comply with the proposed rule including the costs of changing the computer system, training employees on new procedures, obtaining legal counsel on compliance, etc. The Board has an obligation under the RFA to ascertain the costs of the proposal prior to drafting the proposed rule. Failure to do so not only compromises and usurps the purpose of the RFA; it also impinges upon the Board's ability to consider less burdensome alternatives as required by the RFA.

Alternatives

Advocacy further asserts that the Board's consideration of less burdensome alternatives is inadequate. In the consideration of alternatives section of the IRFA, the Board merely states:

“The Board considered whether improved disclosures could protect consumers against unfair loan originator compensation practices for mortgages as well as the proposed rule. While the Board is proposing improvements to mortgage loan disclosures, it does not appear that better disclosures would address loan originator compensation practices adequately.

The Board welcomes comments on any significant alternatives, consistent with the requirements of TILA, which would minimize the impact of the proposed rule on small entities.”⁷

That is not sufficient for RFA purposes.

The purpose of the consideration of alternatives under the RFA is to find less burdensome alternatives for small entities that meet the agency's goals. Although the Board discussed several alternatives throughout the extremely lengthy preamble, there is no discussion about the potential economic impact of those alternatives on small entities or any

⁷ 74 Fed. Reg. at 43321.

indication that the Board considered alternatives that are specifically meant to reduce the economic impact on small entities as required by the RFA. As noted in the IRFA, there are 9,418 small financial institutions and 17,041 mortgage and nonmortgage brokers, the majority of which are small.⁸ As such, it is imperative that the Board provide an analysis of the economic impact of the various alternatives on these small entities. Such an analysis would have provided the public with the necessary information that it needed to provide meaningful comments.

Moreover, by simply stating that the Board welcomes comments on any significant alternatives, it appears as though the Board is shifting the responsibility of considering less burdensome alternatives on the public. Advocacy understands that the industry will be providing the Board with comments on the alternatives in the proposal as well as other reasonable alternatives to consider. For example, the Mortgage Bankers Association (MBA) told Advocacy that limiting the restrictions to vulnerable high risk borrowers and risky loan products would be a viable alternative to the Board's proposal. This alternative would protect the less savvy consumers while carving out an exemption for conventional and FHA loans. MBA also asserts that the Board should consider allowing a percentage of the loan amount to be used as a proxy for determining the appropriate payment.

NAMB also has proposed alternatives for the Board to consider. NAMB has told Advocacy that eliminating the disclosure of the APR and requiring disclosure of payment terms, settlement costs, and the monthly payment would be a viable alternative.

Definition of Finance Charges

Section §226.4 of the proposal changes the definition of finance charge to include things that are not currently included in the finance charge. In the preamble, the Board admits that 3 percent of loans that were below the §226.35 APR threshold would have been above the threshold if §226.4 had been in place at the time.⁹

Small community banks are already having problems adhering to the §226.35 APR threshold. In an October 2009 letter to the Board, ICBA stated that it was receiving a number of calls from community bankers who now see that they must stop offering loan products they have offered for decades, due to the severe restrictions of the earlier Regulation Z amendments. It went on to state that ICBA:

“strongly urges the Federal Reserve to amend the restrictions for “higher-priced mortgage loans,” outlined in § 226.35 of Regulation Z, as they are too restrictive and will limit the availability of the traditional, well-underwritten mortgage loans that are made and held in portfolio by community banks that have a vested

⁸ 74 Fed. Reg. 43320. It should be noted that the office of Advocacy's data indicates that at least 96% of all mortgage broker firms are small. This is based on Census data which indicates that 12,607 out of 13,133 firms have less than five million dollars in revenues. The size standard for determining which mortgage broker firms are small is seven million dollars.

⁹ 74 Fed. Reg. at 43244.

interest in their performance. Many of the mortgage loans that are covered under this “higherpriced” definition are loans that community banks have been providing to consumers in their communities for decades, with no problems. These loan products bear no resemblance to the poorly underwritten loans offered by large lenders and mortgage brokers that the Federal Reserve’s regulatory amendments intended to address. Community banks are alarmed that they must now cease offering these loans that they have offered safely and soundly to generations of borrowers because of the abusive practices of other loan originators.”¹⁰

If the community banks are already having problems staying below the §226.35 APR threshold in the current climate, the proposed changes will only exacerbate their ability to continue to compete in the mortgage market. It may force community banks to require additional escrows which will increase the banks’ operating costs.¹¹ If small community banks stop offering mortgage products, it could be detrimental to consumers (including small businesses) that rely on the services provided by community banks.

Definition of “Loan Originator”

According to NAMB, including lender and mortgage broker businesses in the definition of “loan originator” limits the flexibility and loan pricing and product options that small business entities can offer consumers in the marketplace. Since similar restrictions are not placed on typically larger direct competitors that are able to at least temporarily provide funds for mortgage transactions out of their own resources, competition will be limited and the smaller entities that have had their compensation regulated by the proposed rule will eventually be forced out of the home financing business. Advocacy urges the Board to give full consideration to NAMB’s concerns to assure a level playing field.

Yield Spread Premiums

Section 226.36(d)(1) prohibits compensation payments to brokers or any other originator based on a mortgage transaction’s terms or conditions. These payments are typically called yield spread premiums (YSP). NAMB has informed Advocacy that a viable alternative would be to withdraw the proposed prohibition on payments to loan originators that are based on the terms or condition of the loan and instead require creditors to disclose the lowest interest rate the creditor would accept on a given loan. Based on the Board’s statement in the preamble that to guard effectively against unfairness in loan originator practices the consumer would have to know the lowest interest rate the creditor would have accepted to ascertain that the offered interest rate

¹⁰ Letter dated October 2, 2009 to Governor Elizabeth Duke, Board of Governors of the Federal Reserve System from Cam Fine, President of ICBA, page 2. The letter can be accessed at <http://www.icba.org/advocacy/commentletter.cfm?sn.ItemNumber=1711&navItemNumber=60088>

¹¹ *Id.* at page 3.

represents a rate increase by the loan originator,¹² this alternative should accomplish the Board's regulatory goals. Advocacy encourages the Board to consider this less costly alternative.

Alternative to Permit Compensation Based on the Loan Amount

Although the Board did not discuss an alternative to permit compensation based on the loan amount in its IRFA, it did seek comment on that type of alternative in the preamble.¹³ NAMB and MBA contend that allowing loan originators to retain their ability to receive compensation as a percentage of the loan amount and not just a flat fee would be a less burdensome alternative for small entities. Advocacy urges the Board to give full consideration to this alternative.

Three-Day Waiting Period

The proposal would require creditors to provide a final TILA disclosure to the consumer at least three business days before consummation. ICBA tells Advocacy that this requirement is problematic in some transactions where time may be of the essence. In such a situation, the waiting may compromise the consumer's ability to receive a loan and close on a property in a timely manner. Allowing the consumer to waive the three day waiting period would address this problem. Moreover, NAMB asserts that there should be reasonable tolerances within which certain terms could change without requiring additional disclosure and triggering an additional waiting period. Advocacy encourages the Board to give full consideration to these alternatives.

Effective Date

As noted above, the proposed rule is extremely burdensome to small entities. ICBA indicated to Advocacy that smaller institutions may need at least 18 months and possibly more to comply with the requirements in the proposed rule. Advocacy encourages the Board to provide a longer implementation period of at least 18 months for small community banks and brokers that do not have the same resources to make the necessary changes quickly. Advocacy urges the Board to give full consideration to this alternative.

Delay Implementation of Any Final Rule

Over the last year, regulations have been proposed and finalized to address the mortgage crisis. Advocacy recognizes that there were major problems with the public's understanding of mortgage products and practices under the old rules and landscape. However, changes have been made. Most notably, the Department of Housing and Urban Development's (HUD) Real Estate Settlement Procedures Act (RESPA) rules will go into effect in January 2010. It will change the way that mortgages are handled at a time when consumers are more aware of potential mortgage pitfalls than they were a few years ago. Furthermore, Congress is currently considering legislation to create a new agency, the

¹² 74 Fed. Reg. at 43281.

¹³ 74 Fed. Reg. 43284.

Consumer Financial Protection Agency, which will have broad authority to protect consumers of credit, savings, payment, and other consumer financial products and services. It may be beneficial to the industry and consumers for the Board to delay implementation of any final rule until there has been an opportunity to assess whether the problems in the mortgage market have been addressed appropriately. Such delay would prevent the industry from having to make continuous costly changes to their business practices.

Conclusion

Over the last year, the banking and mortgage industry has gone through extraordinary changes. Many of the changes require retooling of business computers, creation of new forms, changing business practices, and expensive legal counsel to assure compliance. The Board's proposed rule will implement additional changes. However, the Board has provided neither the requisite information about what the economic impact of those changes may be on small entities nor provided/suggested any less burdensome alternatives for small entities. The rationale for this failure to comply with the RFA is that the Board does not have the necessary information.

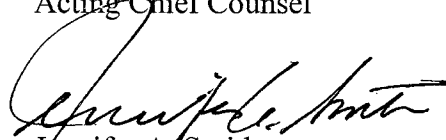
The RFA requires agencies to consider the economic impact on small entities prior to proposing a rule, to provide the information on those impacts to the public for comment, and to consider less burdensome alternatives. Advocacy encourages the Board to determine more accurately the full economic impact on small entities; prepare and publish for public comment a revised IRFA; to identify duplicative, overlapping or conflicting regulations; and to consider significant alternatives to meet its objective while minimizing the impact on small entities before going forward with the final rule.

Thank you for the opportunity to comment on this important proposal and for your consideration of Advocacy's comments. Advocacy is available to assist the agencies in their RFA compliance. If you have any questions regarding these comments or if Advocacy can be of any assistance, please do not hesitate to contact Jennifer Smith at (202) 205-6943.

Sincerely,



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